Russia, Energy and the West

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In Russia's official foreign policy doctrine, published in June 2000, there is not a single reference to oil and gas.[1] Yet the fate of the Russian economy, the dynamics of the new Russian élite and the outcome of the country's still-uncertain post-communist transition are related in no small measure to Russia's vast oil and gas resources. Energy is a key factor in President Vladimir Putin's diplomacy – whether with Iran and Iraq, former Soviet republics or the EU. Energy is also an important subtext in US–Russian relations, both as a source of cooperation and, in some respects, of tension.[2]

The energy factor has been underestimated, if not discounted, in the formation of US policy towards Russia, to the detriment of Russia's relations with the West.[3] Unless they take into account Moscow's concerns about energy revenues and export routes, the US and NATO risk sending the message that they aspire to slow Russia's economic transformation and recovery from the misfortune of being the first de-modernised society of the twentieth century. And the West would do well to appreciate the increasingly important integrative effect that Russian natural gas exports to Europe are having on Moscow's relations with and views of the EU.

Europeans and Americans should not, as Zbigniew Brzezinski so aptly put it, try to engage Russia in a 'one-sided courtship' where emphasis is placed on Western efforts but 'not on Russia engaging the West'.[4] However, the West must also ask how its actions may foster consternation in Moscow, particularly where Russia's vital energy interests are concerned. Certainly, Russia must actively seek to integrate itself into the global economy and existing political and security institutions if its transformation into a pluralistic, market-oriented modern state is to be complete. But this process can only be one of mutual accommodation. Like all nations, Russia has its own concrete interests, some of which will overlap with those of the US and NATO, and others which may conflict. This article explores the areas where energy interests can play a bridging role and where they may create tension or even conflict.

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Securing Market Access

Russia's energy concerns and the related security implications can be divided into four categories: energy exports to Europe; competition in the Caspian Basin and former Soviet Republics; Russian policy toward the Persian Gulf; and emerging and prospective energy exports to East Asia. A careful examination of these areas shows not only the complex influence energy has on Russia's disposition towards its neighbours and the West, but also the conflicting imperatives that energy concerns create for Russia's foreign policy élite. Interpretation of these conflicting aims provides a better paradigm for understanding why Russia seems to have continued old divide-and-rule policies – for example, in Central Asia and the Caucasus – while taking a surprisingly cooperative attitude towards the Western presence in the Balkans.

Energy exports represent more than 20% of Russia's gross domestic product and roughly 50–60% of its total hard currency earnings. The oil sector alone provides 25% of the country's tax base.[5] In 1998, when international oil prices plummeted, Russia's oil-export earnings fell a whopping 30%, contributing to the collapse of its economy.[6] By contrast, Russia's oil-export earnings rose 130% in the first half of 2000 compared to a year earlier; as oil prices have soared so have Russian oil company earnings from both domestic and export sales.[7] Rising oil prices brought Russian oil ventures an extra $2–3 billion in 1999. Moscow brokerage United Financial Group estimates that gross sales for Russia's top oil companies increased 70% in 2000 to $59.2bn, providing $8.1bn in tax revenues for Moscow.[8]

With so much revenue at stake – money needed to rebuild the Russian economy, to bolster its internal stability, to nurture its relations with the 'near abroad' and other nations on its periphery, and ultimately perhaps to rebuild its military capacity – energy policy has a large role in influencing Russia's security perceptions. Russia must secure its access to cash-bearing energy markets just as the US protects its access to affordable energy supplies needed to sustain its economic health. Given the political reality of constrained domestic earnings for major Russian energy firms such as Gazprom – as a result of subsidies and a barter-based economy – the Russian energy industry must focus increasingly on expanding export volumes, and more recently, foreign oil and gas investments. Moreover, just as the US – the world's largest consumer of energy – must guard against a dramatic rise in oil prices, Russia has to worry about any precipitous decline.

From the perspective of a strategic planner in Moscow, the vulnerabilities of Russia's energy-export corridors is a formidable concern. Whereas all of its export routes used to go through Soviet or Warsaw Pact territory, most exports must now cross NATO or prospective NATO countries. Russia exported an average of 2.2 million barrels a day (b/d) of crude oil in 2000, of which only about 850,000 b/d or roughly 40% sailed directly from Russian ports, mainly on the Black Sea (small volumes exit the Barents Sea in the north). All Black Sea oil must clear the narrow Bosporus Strait, which, although considered an international passageway, is ultimately policed by NATO member Turkey. The remainder exits Russia via the Druzhba pipeline system that crosses Ukraine before entering Slovakia and Hungary with connections to Poland, Germany and the Czech Republic, or through the Baltics at the port of Ventspils, in Latvia. Russia is working on refurbishing and reversing the Adria pipeline that extends from Russia to Croatia and to the Adriatic from Ukraine, Hungary and Slovakia.

Figure 1 Russian crude oil exports by port

(thousand barrels / day)		**2000**	**1999**	**1998**
Port				
Druzhba		1,049	1,003	986
	to Germany	388	383	371
	to Poland	357	290	272
	to Czech Republic	74	97	106
	to Slovakia	108	112	106
	to Hungary	122	122	132
Baltic Sea		334	273	292
Odessa		51	111	165
Tuapse		114	103	123
Novorossiysk		699	603	600
Grand Total		**2,247**	**2,093**	**2,166**

Note Baltic exports include Ventspils and Butinge
Source *Petroleum Intelligence Weekly*

In addition, some 80% or more of Gazprom's natural gas exports to Europe must cross the Ukraine.

That Russia considers diminished control of its own export fate as a source of insecurity is evident in Putin's early public expressions of economic nationalism. Putin has declared a planned 450-kilometre pipeline from the oil producing Komi Republic in Northern Russia to the planned port of Primorsk on the Baltic Sea to be a 'matter of national transportation security'.[9] Russian officials are hoping the project, dubbed the Baltic Oil Pipeline System, will help the country lessen its dependence on other Baltic states such as Latvia and Estonia. Although Russia has imposed oil-export tariffs to help finance the new $500m pipeline and costly $3.7bn port, doubts remain about its practicality.[10] The tariff will only raise $100m this year, a fraction of the overall project cost. Moreover, the waters surrounding Primorsk are iced over for more than five months of the year; the ice breakers that would be required inflate the projected costs of exporting oil from there.

In a further attempt to diversify energy export points within its direct control, Russia is also trying to develop oil fields in its northern territories, and the US firm Conoco Inc. may be able to export oil from its YK field directly from the Baltic coast. Conoco's Polar Light field, which was originally slated to utilise the Baltic Oil Pipeline System, is currently selling its Timon Pechora oil production to Russian refineries in exchange for Urals crude for export at the Black Sea.[11]

Clearly, US attempts to use its alliances or wider influence to bring down international oil prices are viewed by Moscow as a sign that its strategic interests conflict with those of the West. And Moscow will take a dim view of US actions that might complicate Russia's influence over the development and/or transport of its oil and gas. This adds another dimension to Russian discomfort with further NATO expansion into the Baltics. Even the expansion of the EU to include countries that are transit corridors for Russia's energy exports could complicate relations between Russia and the West. Few would dispute that a Russian move to control the points of egress from the Persian Gulf would be contrary to Western interests – even if Russia's aims were not hostile. By the same token, it is not entirely unreasonable for Moscow to feel some discomfort in watching the means of egress of its energy exports fall under a Western security umbrella. Still, it is important to note that Putin has of late drawn a distinction between EU and NATO expansion, adopting a positive view of the former. While a host of issues, from the status of Kaliningrad to visas and technical standards, must be worked out, Moscow appears to see virtue in expanding prosperity to its borders.[12]

This is not to say that the US or NATO are likely to choke off Russia's oil and gas lifelines, or that the West must abandon – or even necessarily slow or discourage – institutional integration of those transitional countries who identify with and have transformed themselves to be part of European institutions. However, if in pursuing this transition the West does not clearly offer, as Brzezinski has argued, 'the progressive inclusion of Russia in the expanding transatlantic community', or if it ignores Russia's strategic imperatives in regard to transit countries, it should not be surprised if Russia perceives Western policies as contrary to its interests and acts accordingly.

Inclusive Western policies towards Russia would underscore that EU and NATO expansion are compatible with – and even serve – long-term Russian interests. By stabilising the economies of the transit countries, instituting effective rule of law and arbitration mechanisms and reducing corruption, EU and NATO membership could ultimately result in these countries being more reliable outlets for Russian energy exports. The problem, of course, is that in the real world, neither Russian nor the West's behaviour easily lends itself to black and white interpretation, but rather, is often a shade of grey. At present, much of Russia's élite are smarting from perceptions – justified or not – that the US has in recent years tried to force Moscow to accept American decisions and conditions without sufficient regard to legitimate Russian interests. [13]

Russia's Energy Links to Europe

Energy contributes an important and developing link between Russia and Europe. Russia currently exports between 2.0–2.5m b/d of oil and an annual 136bn cubic metres of natural gas to Europe (including Ukraine), about 20% of

Figure 2 Russian gas exports

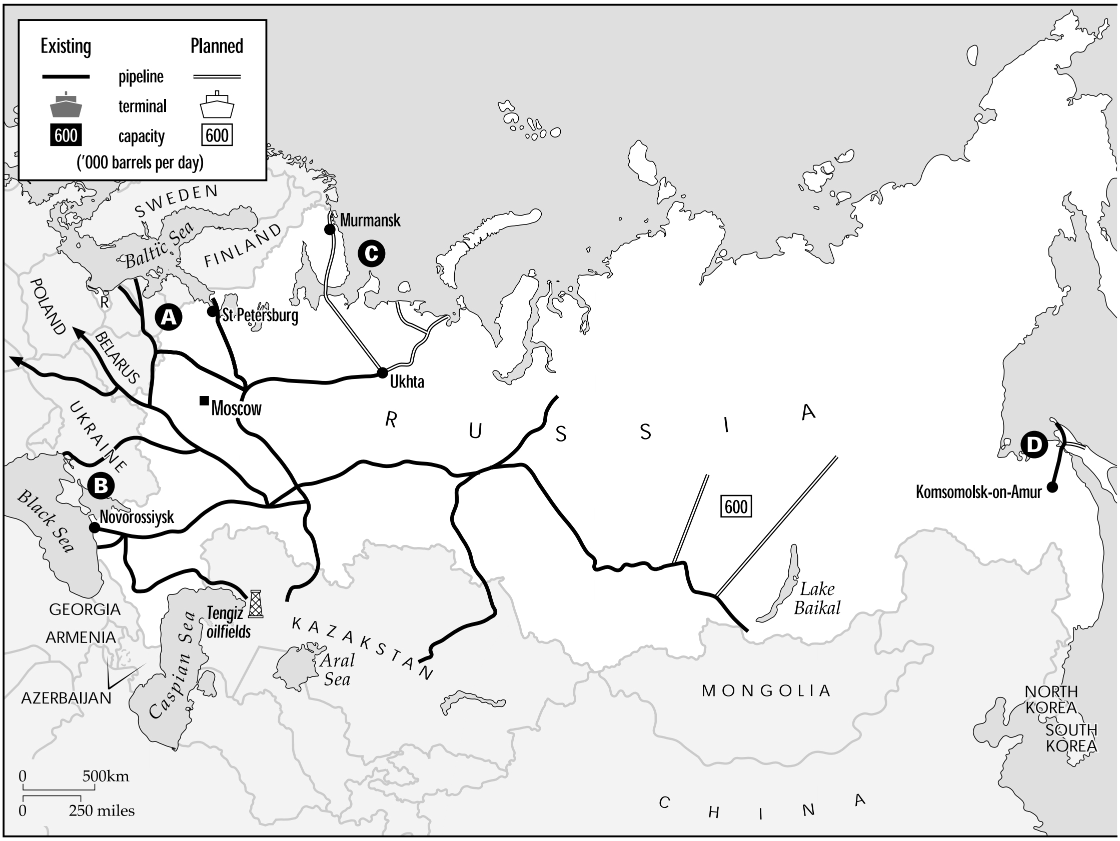
(BCM)	**2000**	**1999**
Austria	5.1	5.4
Bosnia-Herzegovina	0.3	0.2
Bulgaria	3.2	3.2
Croatia	1.2	1.2
Czech Republic	7.5	7.8
Finland	4.3	4.3
France	12.9	13.4
Germany	34.1	34.9
Greece	1.6	1.5
Hungary	7.8	7.4
Italy	21.8	19.8
Macedonia	0.1	0.04
Poland	6.9	6.1
Romania	3.2	3.2
Slovakia	7.9	7.5
Slovenia	0.7	0.6
Switzerland	0.4	0.4
Turkey	10.3	8.8
Yugoslavia	1.2	1.1
Total	**130.3**	**126.8**

Source PIRA Energy Group

Europe's gas needs and 16% of its oil supplies. Germany, Poland and Italy are the largest customers.[14]

In October 2000, Putin signed a strategic energy partnership with the EU that will allow natural gas exports to Europe to rise to 200bn cubic metres by 2008.[15] As part of the arrangement, Russia's gas monopoly Gazprom will form a consortium with leading gas companies from Germany, France and Italy to build a $2bn gas pipeline to carry an additional 60bn cubic metres of gas to the EU each year via Belarus, Poland and Slovakia.[16] The deal is significant because it will allow Gazprom to bypass Ukraine, which owes Russia over $2bn for gas imports and is accused of siphoning off gas destined for European customers.[17] Ukraine's massive debt to Moscow stands in sharp contrast to Western Europe, which is the highest-paying market for Russian gas. Conversely, Russia is Europe's cheapest supplier, given the lower cost of transport. Economic motivations are clearly central to both Russia and Europe, though key EU members, such as Germany and France, appear to have an appreciation of other benefits – such as the long-term political benefits of an established economic relationship.

Map 1 Russia: oil pipelines



Some analysts have raised questions about whether Russia will be able to meet rising demand for its natural gas exports, given the poor condition of its gas fields and shakiness of its gas industry. Russia's reserve base is vast but operating fields will require huge investment just to prevent a slide in output rates. New fields, such as the Astrakan field, can be developed but capital may be a constraint.

To keep Russia's gas industry going, European firms will have to help with financing. So far, Europe's gas firms and the European Bank for Reconstruction and Development (EBRD) have shown a willingness to provide capital to ensure supply, such as the investment by Germany's Ruhrgas in Gazprom which was used to repair gas-export infrastructure such as pipelines. Russia may also be able to supplement its own gas supplies with shipments from the Caspian region. Russia now imports roughly 40bn cubic metres per year from Turkmenistan – which in its heyday produced twice as much – while Kazakstan is already feeding gas to Orenburg in Russia.

The mutual pecuniary impetus for the new EU–Russia natural-gas pact aside, it has clear strategic implications. Accompanying this pact was an EU

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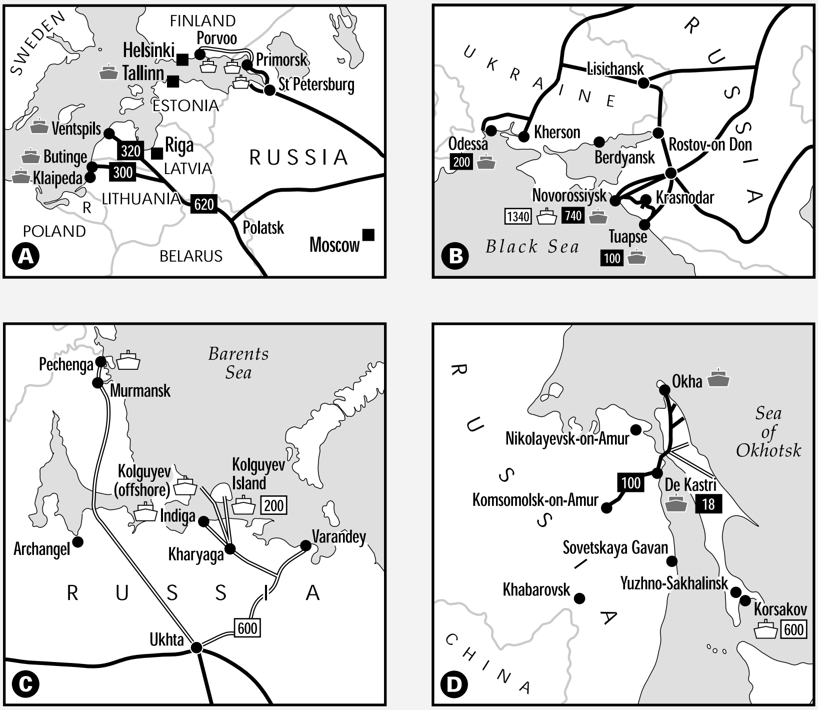

Source: Troika Dialog

statement framed in far milder language with regard to Russia's military operation in Chechyna than a previous EU statement in 2000, which had strongly condemned Russia's intervention.[18] The deal and its accompanying softline statement raised eyebrows in the US , but was hailed in Europe as a constructive way to eliminate Russia's burdensome debt while enticing Moscow to moderate its positions on European security. EU spokesman Jonathan Faull noted that the EU wanted to 'change the commercial relationship into a long-term strategic partnership that will help stabilise Russia, which is in the interests of all parties'.[19] From a Russian perspective, it brings Moscow closer to Europe, and creates larger stakes for both in mutual energy security. It may also be viewed by both as providing potential insulation against US pressure. Russia's supplier relationship with the EU would seem to offset – or at least counterbalance – any sense of vulnerability Moscow perceives in regard to its export routes. Not insignificantly, it also fosters for both a strategic calculus apart from the US.

In cultivating long-term markets in Europe – and staving off competition – Moscow will increasingly have to take EU and NATO foreign-policy preferences into account. Naturally, the fact that Russian behaviour on issues of most concern to Europe – NATO's operations in Kosovo, the removal of Milosevic, NATO expansion and trade – has been relatively conciliatory cannot be attributed solely to Russian energy interests. But it does lend credence to the view that a Russia that needs Europe as an energy customer is a Russia that might have a larger incentive to make the transition into a state with values more in tune with Western norms. At a November meeting of the Organisation for Security and Economic Cooperation (OSCE) in Berlin, Russian Foreign Minister Igor Ivanov invoked the new energy partnership when raising the prospect of Russia cooperating militarily with Europe in tackling international crises. 'Oil and gas pipelines are blood vessels to the economic body of Europe. But by no means the whole organism', he said.[20]

The situation is different for nearby countries whose transit role is vital to Russia's energy industry, and for whom Russian energy exports are as much a source of tension as they are political bridges. Now that these countries are no longer subsumed within the Soviet Union or the Warsaw Pact, Russia needs to establish more nuanced diplomatic relations with them. So far, Moscow appears to be having some difficulty with this transition, and has resorted to bullying, blackmailing and otherwise interfering in the sovereignty of its neighbours. In some cases, the motive is simply money: Ukraine owes Russia nearly $2bn for gas, Moldova owes $861m and Georgia $179m. In relation to their respective state budgets, these debts are enormous and cannot be easily discharged.[21]

Ukraine especially has proven deft at doing Russia out of large amounts of natural gas while at the same time crying to the West that Moscow is threatening its independence. Russia's new pipelines and export routes will simply bypass the Ukraine in favour of more efficient routes yielding higher net profits. Russia also occasionally pressures a third party – most recently the Turkmens – to supply the Ukraine with gas, so that someone else will be stuck with Kiev's unpaid bills. Russian companies are allowing Belarus and Ukraine to settle some debt by transferring ownership of industrial assets, such as oil refineries. Of the two, Belarus has been more forthcoming in offering political and industrial accommodation in exchange for debt cancellation.[22] Ukraine has tried to stake out a more independent course by importing oil from other sources, but its current lack of funds make this a difficult strategy.

Several times in the first half of this year, Russian companies cut off natural gas supplies to the Ukraine and Georgia to force payment of debts. Russian gas giant Gazprom is now suing Ukraine to pay for gas that Kiev has allegedly siphoned from the pipeline transiting its territory. Meanwhile, Kiev has agreed to increase its military integration with Russia, a concession that knowledgeable observers link to the pressures from gas cut-off. In Georgia, the government agreed to share its electricity grid with Russian electric utility United Energy Systems (UES), a move that meant US firm AES will lose its access to facilities on the border of Georgia and Turkey. The Shevarnadze government also agreed not to pursue NATO membership. The regional press speculates widely about Russian intelligence involvement in political scandals in all three countries, generating the impression – misguided or not – that Moscow has not changed its ways ten years after the dissolution of the USSR.

The Caspian

Russian interests in the European energy market seem likely, on balance, to be a factor for moderation. Its energy links to the Caspian Basin are more unsettling. Inside Russia, there are those who worry that the importance of the Caspian countries – Kazakstan, Turkmenistan and Azerbaijan – as oil and gas exporters could surpass Russia's own if Western oil companies' investments in the Caspian region are successful.[23] Some Russian analysts even worry that Russia's oil industry might decline so much that oil and gas resources from the Caspian might be needed some day to fuel Russia's domestic economy.[24]

There are also geopolitical concerns. The presence of Western oil companies on Russia's borders and high political profile given to Central Asia by Washington raises fears that the US military will not be far behind with a new mission. Such fears have been exacerbated by the forging of US military ties with most of the former Soviet republics in the Caspian Basin and southern Caucasus and their inclusion in NATO's Partnership for Peace (PfP) programme.

There are, to be sure, instances of Russo-Western cooperation, such as the Russian company Lukoil's participation in Western oil consortia in the Caspian (an arrangement that has caused some tensions between Lukoil and the Russian Foreign Ministry).[25] In one sense, investment by Russian companies in the Caspian could turn those companies into natural lobbying groups for cooperation between Moscow and the Western consortia. But the advent of the Caspian countries as large-scale energy exporters under Western tutelage is more generally seen as a threat, especially to Russia's growing sales to Europe.[26]

In April 2001, Putin met with Russian oil industry leaders, urging them to take a more active role in the Caspian. A Russian Foreign Ministry statement captured prevalent attitudes:

> The Security Council of the Russian Federation proceeds from the premise that the scale of Russia's interests on the Caspian direction determines the necessity of its comprehensive presence in the region and of the pursuit of a more vigorous political line there ... We intend to firmly uphold and promote our lawful interests in the Caspian that no one has the right to impinge upon.[27]

Putin's directive could be interpreted as simply a call for Russian business to compete with Western firms, such as the Blue Stream project, which will compete with US-led projects for sales to Turkey.[28] Yet, at the same time, Russia has used its geographic dominance – its control of major port and pipeline outlets in the Caspian region – and the weakness of the former Soviet Republics to pursue political goals and to hinder Western energy projects opposed by Moscow. Until recently, Moscow's support for secessionists in Georgia and for

Armenian hardliners seeking the independence of the enclave of Nagorno-Karabakh was viewed as evidence of Russia's determination to limit the independence of states in the region. However, the recent warming of Moscow's relations with Azerbaijan has led to a collaborative posture underscored by Putin's January 2001 visit to Baku. This new approach – offering its export routes for Azerbaijan's energy – suggests an effort to counter US Caspian diplomacy with economic and political engagement.

In the early 1990s, Russia attempted to retain influence over Caspian oil developments in a number of different ways. It played a 'spoiling game', slowing down or impeding negotiations for export routes from Kazakstan and elsewhere, and used its political influence and advantageous geographical position to ensure a partnership role for Russian companies.[29] Secondly, until a Russian company made a major discovery in its own Caspian offshore sector last year, Russia's Foreign Affairs Ministry raised legal challenges about the status of resources in the Caspian Sea, in effect warning potential investors in the Caspian that Russia's blessing would be vital to the success of future Caspian projects. More recently, Russia has implied that legal objections could be levied against a US-inspired trans-Caspian gas pipeline on environmental grounds.[30]

The influence of Russian oil companies on Russian policy in the Caspian is already apparent, despite hardliners who would like to thwart energy exports from Kazakstan and Turkmenistan, to assert Russian control of these resources and to keep foreign companies out of Russia's backyard. In recent months, Russia has increased Kazakstan's quota for shipments into the Russian pipeline system (for export to Europe) to 14m tonnes for 2000, up from a previously specified volume of 10m tonnes. The Russian company Transneft is also inviting Caspian neighbours to use a new pipeline to Makhachkala on the Caspian's western shore in Azerbaijan.[31] Exporting through Russia is the most viable option for Kazakstan because it obviates the need to cross the Caspian Sea or follow a wide span of its coastline before connecting to existing or proposed pipeline export facilities in third countries. It is hoped by Kazak oil producers – including several Western oil companies – that Russia will be able to provide security for the new pipeline from Kazakstan that will extend from the large Western-run Tengiz oil field through Russia to Novorossyisk. The pipeline, operated by the Caspian Pipeline Consortium (CPC), which includes US, Kazak and Russian oil companies, will initially carry 28m tonnes of oil per year from Kazakstan to Russia and then on to the West via the Black Sea. It is expected to be in operation by late 2001.[32]

Russia's Gazprom is working to thwart any competition from Caspian natural-gas producers in its key Western markets – such as Turkey and Europe – by refusing access to its pipeline network. Instead, the Russian gas giant is simply buying Caspian gas on the cheap for use in Russia, freeing more Russian gas for export. Turkmen President Saparmurat Niyazov reached agreement last year to sell Gazprom as much as 30bn cubic metres of natural gas a year.[33] Gazprom will reportedly deliver some of the gas to domestic energy giant United Energy Systems.[34] The agreement, together with the ground-breaking of the Russian–Italian Blue Stream pipeline, could result in an operational system well before the US-backed programme to bring Turkmen and Azeri gas under the Caspian Sea via pipeline to Turkey.[35]

The Blue Stream consortium, which includes Gazprom and Italy's ENI conglomerate, has announced that it has arranged $1.7bn credit from Banca Commerciale Italiana, Mediocredito Centrale and Westdeutsche Landesbank, with an additional $660m expected from the Japan Bank for International Cooperation and Japan's Ministry of Economics, Trade and Investment (METI).[36] Construction of the pipeline has already begun, giving Russia a further advantage in enlarging its already-sizeable share of the Turkish gas market. The success of this project is a major blow to US-organised projects in Central Asia in that it takes up a good chunk of the potential Turkish gas market from Turkmenistan and Azerbaijan via the Caspian Sea and Georgia. Russia sells about 6bn cubic metres per year to Turkey at present, but this could rise to as much as 30bn if expansion projects such as the Blue Stream pipeline stay on track.

Competition for the Turkish gas market marries two conflicting trends in Russia's Caspian policies. In strict commercial terms, it allows Gazprom to cash in on a profitable market, relying on cheaper imported Caspian gas to fill any supply gaps that might be created in less lucrative domestic markets. At the same time, Blue Stream satisfies Russian neo-imperialists who would like to woo Turkey into blocking US companies from gaining a foothold in the Caspian. A Turkish market saturated with Russian supplies will have far less room to commit to gas purchases from American-led export projects from Turkmenistan, Azerbaijan or Kazakstan.

As a possible bonus, Turkey's surprising commitment to buy more Russian gas via Blue Stream has raised questions in Washington about Ankara's faithfulness to the Eurasian Energy Corridor concept, centred on a Baku–Ceyhan pipeline linking the Caspian to the Mediterranean. The Baku–Ceyhan link is aimed at isolating Iran, curbing Russia's hold on regional energy supplies, creating stronger links between Turkey and the countries of Central Asia and the Caucasus and freeing them from undue Russian influence. If Turkey has enough confidence in Moscow to link its economy so significantly to Russian energy, then much of the underlying logic of the US policy promoting the Eurasian energy corridor (that is, excluding Iran and minimising Russian routes to Turkey's benefit) is eroded.

East Asia

The export of Siberian oil and gas resources to East Asia constitutes another potentially important engine of Russia's economic development and foreign policy goals. This energy bridge has already helped Russia establish closer economic and diplomatic relations with both China and Japan. Bilateral energy-trade relations with East Asia also open the possibility of Japanese and South Korean investment capital and technology, desperately needed by Russia's ailing – due to lack of investment and technological modernisation – oil and gas sector.

The end of the Cold War and the rise of China has opened up new possibilities for collaborative ventures between Russia and Japan. Tokyo has lowered the heat on the territorial dispute over the Kuril Islands, seized by Russia at the end of the Second World War. Japan seeks better relations with Russia both to balance China and to reduce its dependence on Middle East oil and gas. Russia seeks a lucrative hard-currency market and a source of investment capital. At the same time, the development of energy resources in the Russian Far East potentially benefits China, with its growing energy needs, allowing it to diversify from seaborne imports that Beijing fears could be blocked by the US Navy. Japan is happy to see Russian oil and gas flowing to China, since Tokyo worries about the effects of energy shortages on China's international behaviour. Japanese companies have invested in two of the four major oil and gas projects in Sakhalin Island in the Russian Far East. Discussions are continuing on a long-term project to build pipelines from Irkutsk and Yakutia in Russia to China, Japan and the Koreas.

Oil from the two projects in Sakhalin is already flowing. Sakhalin is only 600 kilometres from Japan's northern island Hokkaido, and as political and economic constraints stymie any expansion of Japanese nuclear power, Sakhalin's natural gas will become an increasingly attractive alternative source of clean energy.[37]

Russia's proven and probable gas reserves in Sakhalin may be us high as 1.4-1.8 trillion cubic metres. By comparison, Indonesia, the world's largest exporter of liquefied natural gas (LNG), has proven reserves of 2.3 trillion cubic metres. In addition Yakutia is believed to have 1 trillion cubic metres, while Irkutsk may hold still larger amounts, though they may be more problematic to exploit.[38] Putin himself has offered a vision of 'sweeping plans for the creation of an energy bridge from Russia to Japan via Sakhalin, the construction of gas pipelines from the Tomsk Region to Western China, and from Irkutsk to Eastern China and on to North and South Korea'.[39]

The further exploitation of Russian Far East gas will almost certainly require financing from Japan and Korea as well as from China. All three North-east Asian nations are significant and growing consumers of natural gas, and all would relish the prospect of alternative supplies to those from the Middle East. Beyond Sakhalin, however, it is still unclear how large gas reserves in Irkutsk, around Lake Baikal in Western Siberia, may be, and the economic benefits of laying long pipelines to these areas are just as problematic. The payoff from such ambitious projects are 10–15 years away at the earliest. Construction of a large-scale pipeline for gas from Irkutsk or Siberia to China and Japan will be costly, technically challenging and politically complex to negotiate. For example Yukos, one of Russia's largest (publicly owned) oil companies, has been negotiating with the Chinese government to build a pipeline connecting eastern Siberian oil fields to China, but the roughly $4bn project has foundered over financing and Russian demands for long-term oil purchase commitments needed to obtain it.[40] For the time being, the political confidence to depend on multinational pipelines for vital energy supplies is lacking. Nonetheless, over the long term, gas is likely to be an important factor in Russia's integration into the East Asian political economy.

The Persian Gulf

The March 2001 visit of Iranian President Mohammed Khatami to Moscow and the expanded military and nuclear cooperation between Russia and Iran underscores Moscow's controversial posture in the Persian Gulf.[41] Russia has two serious economic considerations where the Middle East is concerned. First, a domestic constituency earns substantial income from this arms market. In particular Iran, with purchases exceeding $4bn between 1992 and 2000, is now the third largest customer of Russia's weapons industry.[42] Second, Russia benefits from tensions in the Middle East if such tensions produce rising oil prices. As an energy exporter, Russia's security interests in the Middle East are rather different from those of the oil-importing United States. The petrol queues in Europe in autumn 2000, aggravated by Iraqi sabre-rattling, sent the EU into the arms of Gazprom. Russian oil companies are profiting from discounted Iraqi oil-sales contracts, and Moscow, as a competing oil exporter, benefits from the constraints placed on potential Iraqi oil exports by United Nations sanctions. Indeed, Moscow is in a perfect position, as members of Putin's inner circle have noted privately.[43] It can take Baghdad's side in arguing for an easing of sanctions without worrying about the economic consequences for itself if sanctions were actually lifted, since it can rely on (and at the same time scold) the US for blocking such a move.

Russian sales of advanced weapon systems to Iran raise a more ambiguous issue. Moscow has historical and geographical reasons to pursue a good neighbours policy with Tehran and it benefits greatly from sales of arms and other manufactured products to Iran. The two countries also may have overlapping interests in limiting the US economic and military presence in Eurasia. Likewise, to the extent that Russian arms sales to Iran complicate the possibility of a US–Iranian rapprochement, they help to maintain the American incentive to block the development of Iran's oil and gas assets. That means thwarting a potential competitor with Russia for the European and potential Asian markets.

But Russia will have to consider carefully where to draw the line on such sales. Transfers of nuclear or ballistic-missile technology is likely to draw the ire of the US and its allies unless reform in Iran is so extensive that its capabilities would be viewed as less of a threat. At present, political trends in Iran are moving in the opposite direction. Russian nuclear and missile-technology transfers to Iran could damage the extent of cooperation with the West on other more important European issues. Perhaps most compelling, Russian politicians, such as Duma Defence Committee deputy chairman Alexei Arbatov, have noted that technology transfers to Iran could backfire by directly or indirectly arming Islamic elements that might eventually turn their attentions to Russia.[44]

In any event, Russian strategies aside, Persian Gulf instability is unlikely to sustain energy prices in the long term. Renewed competition among key

Middle East producers as they reopen their oil fields to foreign investment, combined with technology breakthroughs in the automotive industry, make it unlikely that oil prices will remain over $20 per barrel in the very long term.[45]

Russian Energy and Western Policies

EU countries appear to view the energy connection with Moscow both as a good deal commercially and a strategic investment in Russia's political and economic transformation. Russia needs the EU market more than the EU needs Russian oil and gas. The range of alternative suppliers in Europe, Africa and the Middle East would seem to mitigate EU dependency on Russia. A long-term steady and growing energy partnership with Europe will give Russia a stake in the EU's future, provide a means to transform Russia's economy, and perhaps begin to foster a sense of connection with a steadily expanding definition of Europe, if not one of association with the EU as a security community. In any case, such a evolving interdependence takes some of the sting out of the ongoing NATO expansion.

Russia's relationships with energy-transit countries such as Ukraine and Belarus pose a more complex challenge for US policy, which tends to favour former Soviet republics seeking independence from Moscow's sphere of influence. Access to energy corridors is a vital Russian interest; Moscow understandably finds loss of control over such access discomfiting. And in fact, the free flow of oil and gas from Russia to Europe is also in the US interest. But the United States is unlikely to abandon completely any country that aspires to escape or dilute Russia's economic or strategic dominance, especially insofar as Moscow exerts its influence in a heavy-handed manner. One problem for US and NATO policy-makers is that the line between pressure to obtain payments for energy and use of energy dominance as leverage for political objectives has tended to be blurred.

These overlapping Russian motives tend to complicate US support of ex-Soviet republics against their former master. The US has a special relationship with Ukraine that was established in 1993–94 when Kiev agreed to turn over its nuclear arsenal in exchange for explicit US security guarantees. But the US found itself at a loss when, after two years of financing the repayment of Ukraine energy bills to Russia, new debt appeared to be mounting as rapidly as it had been retired.

Developments in the Caspian Basin have not quite worked out as either Moscow or Washington had anticipated. Central Asian states have proven adept at playing off outside actors against one another (Russia, Iran, Turkey). Russia's desire to exclude the US from its Caspian backyard is unrealistic in either economic or political terms – and is starting to be recognised as such by the Russians. Development of Caspian oil and gas is already dominated by Western consortia (albeit with some Russian participation). But Russia can still assert itself by impeding those consortia from moving forward rapidly, by interfering with its needed transit facilities or by offering more attractive possibilities through its existing energy transit infrastructure. Moscow may also be starting to realise that hindering the development of its former Soviet republics in Central Asia may not serve its best interests: the instability, poverty, disease, drug and arms smuggling, and not least, rising Islamic fundamentalism in the former Soviet republics of the Caspian region have begun to create a sense of common interest between Moscow and many of the governments of Central Asia. This is evident in Moscow's new approach to Azerbaijan, the development of the 'Shanghai Five', (Kazakstan, Kyrgyzstan, Tajikstan, Russia, China) security arrangements, and more broadly, growing anti-terrorist cooperation between Russia and its former republics in Central Asia.

But the US has also had to struggle to put its policy towards the Caspian basin on a more realistic footing. The policy's centrepiece, the Baku–Ceyhan pipeline, was intended, in part, to support Turkey's effort to reduce Russia's stranglehold on the Central Asian countries and Azerbaijan, and, by offering an alternate transport route – one that avoids the crowded Bosporus (though Baku–Ceyhan's main purpose is to isolate Iran and boost Turkey.) The continued authoritarian character of the governments in the region has also diminished American fervour for political involvement in the Caspian. Even in the event of higher than expected flows from Kazakstan's Kashagan field, the region's output – overwhelmingly dominated by Western-led consortia – is still unlikely to meet more than 4% of world oil demand by 2010–15. This does not rise to the level of a vital US interest. Moreover, if the Kashagan field proves as large as many have imagined, and can produce 1.5m b/d or more, then the pipeline politics may be resolved with fewer losers.

If neither Russia nor the US is likely to succeed in excluding the other from the region, it may be time to realise that they (along with Turkey) have significant common interests in the area: regional stability; countering radical Islam; opposition to the *Taleban*; commerce and economic development; fighting drug-smuggling from Afghanistan and Central Asia; and a reduction of human suffering and ethnic warfare. The Afghan drug trade is corrupting the Russian army and police to the point where it is beginning to pose a threat to Russian stability. Events in Chechnya and Tajikistan have demonstrated the costs to Russia of discontent and instability on its borders. A more cooperative stance would benefit everyone. Despite some tensions, joint peacekeeping operations in Bosnia and Kosovo have created positive precedents. Moscow's more amicable ties to Baku and diminished backing for Armenia open new possibilities for cooperation on conflict-resolution. That US-sponsored negotiations to resolve the Nagorno-Karabakh dispute between Azerbaijan and Armenia was one of the first diplomatic initiatives launched by an otherwise-cautious Bush administration is a response to the shift in Russian policy. There may even be new opportunities for multilateral diplomacy, including a Central Asian variant of ASEAN (the Association of South East Asian Nations) that would emphasise economic cooperation and limited security goals.

Strategic Convergence?

Finally, the US has its own compelling interest in seeing Russia's energy sector rehabilitated and modernised and its exports to Europe increase. Russia and the newly independent states of the former Soviet Union are ranked second in undiscovered oil potential after the Persian Gulf, holding an estimated 27% of the world's undiscovered reserves. The region (Russia and former Central Asian republics) ranks first globally in undiscovered natural gas potential and will be an important supplier to Europe and possibly Asia.[46] Russia accounts for 13% of the world's energy production, third after Saudi Arabia and the US. Regardless of the attitudes of US conservatives, Russian oil and gas supplies, even without Caspian Basin considerations, will be critical to the expanding world economy, whose oil requirements continue to grow at 1–3% per year and could reach 94m b / d by 2010, up from 77m b / d currently.

The deterioration of the Russian oil industry in recent years has been remarkable and a critical factor in the tightening of supply to the world oil markets. Russia holds the world's eighth-largest proven oil reserves. But Russia's political and economic problems have discouraged both domestic and international investment, though this is beginning to change. Russian oil production fell to less than 5.9m b / d in 1999, down from 12m b / d in the late 1980s. In 2000, it rebounded by 4.7%, following a 25% increase in reinvestment by Russian oil companies in 1999 and a doubling of total investment in 2000. Investments have included repairs and improvements to existing wells and only limited new development drilling, but there have been few new major fields discovered in the last two years. Washington-based consultants Planecon say it will take some $140bn in new investment between 2000 and 2020 to keep oil output increasing. To put this in perspective, total foreign direct investment in exploration activity totalled only $3.6bn during the last decade, providing about 20m tonnes or 6% of Russian oil production in 1999.[47]

In fact, the United States could significantly enhance its own energy security by assisting Russia to revive its energy industries. Direct aid for the expansion of Russian oil and gas fields would provide Moscow with an incentive for adopting more transparent market-oriented policies. Energy should be accorded a much higher status in US–Russian relations, as a critical element of a US approach for integrating its Cold War adversary into the post-Cold War international system. In practice, American policy has been more muddled: such elements as NATO expansion, the bombing of Yugoslavia and US Caspian ambitions have not been reassuring to Moscow. They suggest, as Michael Mandelbaum observes, that 'Russia has been and is being ignored where its own definition of its interests is concerned, and being ignored contrary to what Russia believes were Western assurances'.[48]

There is, to be sure, an obvious counter-argument: that a Russia flush with oil and gas revenues would be more capable of rearming and challenging Western interests. [49] The prospect of a stronger and more hostile Russia puts current US energy security policy, at least potentially, into direct conflict with the United States' broader geostrategic interests.

The long-term threat of a revived, neo-imperial Russian hegemon can not be dismissed out of hand. However, US policy based on such a worst-case scenario carries the danger of becoming a self-fulfilling prophecy. In reality, the material needs of the Russian people are so huge, and the deterioration of the

Russian military so deep, that the potential of improved oil revenues to bring Russia back to a position where it could dominate its neighbours, much less threaten the United States, is remote.

Moreover, it is also the case that the reforms of business and legal culture necessary to achieve such a revival would tend to mitigate against a return to East–West confrontation. Western assistance, particularly in technical and legal areas, the 'software' of economic reform, can be important, and US policies should be designed to encourage the Russian government to improve the climate for foreign direct investment and the rule of law (in such areas as the protection of private property and securities laws). A focus on more attractive Production Sharing Arrangements (PSAs), a more normal commercial legal framework and transparent arbitration mechanisms are the minimum prerequisites for attracting the levels of foreign investment necessary to revive the Russian oil industry. So far, Russia's energy sector, like the rest of its economy, has made only ambiguous progress in this regard.

Conclusion

The energy sector can catalyse a Russian recovery and economic modernisation – or reinforce its current, corrupt morass. In either case, energy matters hugely. It can be a source of conflict, but it also offers much scope for cooperative activity between Russia and the West. There have been hopeful developments in this regard, including the burgeoning EU–Russian energy collaboration; cooperation with Japan and other countries in development of Russian Far East energy; and Moscow's more accomodating policies *vis à vis* Azerbaijan, which are allowing conflict resolution on Nagorno-Karabakh to move forward.

To the degree Russia's energy sector is rehabilitated and modernised, it has the potential to sharply diminish OPEC's role in world oil markets and facilitate expansion of the use of clean natural gas at a time when global warming concerns are mounting. Such possibilities underscore the necessity for US foreign policy of better accounting for the importance of energy issues in Russia's foreign relations.

Since the mid-1990s, with the dying of post-Cold War optimism, US–Russian relations have been plagued by mistrust and miscommunication. Since coming to power on New Year's Day 2000, the Putin government has promoted a more hard-line definition of Russian interests. In responding, the US must recognise Russia's real strategic concerns, and if necessary, determine what policy trade-offs – if any – the US and NATO can accept. This means distinguishing between Russia working to protect the transport of a vital export commodity and Russia refusing to renounce its 'imperial past'. The challenge to Western diplomacy is how to accommodate legitimate Russian interests without jeopardising US and NATO interests. A proper analysis of the energy element in Moscow's foreign policy can help Western policy-makers map a more cooperative fit between Russian interests and Western security, or at a minimum, provide a more productive dialogue where the two cannot be fully resolved.

Notes

[1] 'The Foreign Policy Concept of the Russian Federation', Moscow, 28 June 2000. See www.mid.ru/mid/eng/econcept.

[2] See Lee S. Wolosky, 'Putin's Plutocrat Problem', *Foreign Affairs*, March/April 2000, pp. 18–31, for a good overview of the role of oil and gas in shaping Russia's new oligarchy and how its corruption impedes both the development of the energy industry and, more broadly, the market economy.

[3] See for example, Ariel Cohen, 'Putin's Foreign Policy and US–Russian Relations', Heritage Foundation backgrounder, 18 January 2001, www.Heritage.org ; Stephen Sestanovich, 'Where Does Russia Belong', *The National Interest*, Winter 2000/01; pp.6, 8; 'Russia's Road to Corruption', House Republican Policy Committee (Rep. Chris Cox, chair), report to the US Congress.

[4] Zbigniew Brzezinski, 'Living with Russia', *The National Interest*, Fall 2000, pp. 16.

[5] Peter Rutland, *Lost Opportunities Energy and Politics in Russia*, The National Bureau of Asian Research, Vol. 8, No. 5 1997; presentation by Matt Sagers to a conference on world oil supplies at Florida International University 16, November 2000. Sagers is a consultant with the Washington DC-based firm Planecon.

[6] Sagers, *ibid.*

[7] Interfax, as reported by Radio Free Europe, 15 August 2000.

[8] Paul Starobin and Catherine Belton, 'The Oil Gods must be Smiling', *Business Week*, October 30, 2000 p. 170–171.

[9] See Vijai Maheshwari, 'Baltic Oil Access Wakens New Russian Pipeline Dream', *Financial Times*, 30 March 2000, p. 38.

[10] http://bisnis.doc.gov/bisnis/isa/9901port.htm

[11] Author's telephone interviews with Conoco officials, Houston, 28 November 2000.

[12] Stefan Wagstyl, 'Intense Suspicion Gives Way to Support', *Financial Times*, 9 April 2001, p. 3, Russia supplement.

[13] Michael Margelov in 'Energy in the Caspian Region: Past and Future', Amy Myers Jaffe, Yelena Kalyuzhnova, Dov Lynch and Robin Sickles (eds), Macmillan, forthcoming.

[14] Data provided by PIRA Energy Group.

[15] See Peter Norman, 'EU and Russia to Strengthen Energy and Security Ties', *Financial Times*, 30 October 2000, p. 10.

[16] William Drozdiak, 'EU Near Energy Deal with Russia', *The Washington Post*, 20 October 2000, p. E03.

[17] 'Gazprom Gets Clients Behind its Bypass Gambit', *World Gas Intelligence*, 14 September 2000, vol. XI no. 17, p. 1.

[18] Ariel Cohen, 'Putin's Foreign Policy and US–Russian Relations'.

[19] Drozdiak, 'EU Near Energy Deal with Russia'.

[20] Haig Simonian, 'Russia Seeks to Strengthen ties with EU,' *Financial Times*, 27 November 2000, p 7.

[21] Cited in Anatol Lieven and Celeste Wallander, 'Make Russia a Better Neighbor,' *New York Times*, 14 March 2001, p. 23A.

[22] Peter Rutland, 'Oil, Politics and Foreign Policy', *The Political Economy of Russian Oil*, David Lane (ed.), (Lanham, Maryland: Rowan & Littlefield Publishers Inc., 1999), p. 163–188.

[23] Yuri E. Fedorov, 'Russia's Caspian Policy under Vladimir Putin', *Private View Magazine*, November 2000, p. 3.

[24] Author's interviews with Russian energy analysts and officials in Moscow, February 2001.

[25] See Federov, 'Russia's Caspian Policy under Vladimir Putin' for competing Russian views of the Caspian region, p. 4.

[26] *Ibid.*

[27] A Ministry of Foreign Affairs directive around the same time states 'The Security Council of the Russian Federation proceeds form the premise that the scale of Russia's interests on the Caspian direction determines the necessity of its comprehensive presence in the region and of the pursuit of a more vigorous political line there … We intend to firmly uphold and promote our lawful interests in the Caspian that no one has the right to impinge upon.' Ministry of Foreign Affairs, Russia Fact Sheet N 396. 11 May 2000.

[28] See James M. Dorsey, 'Turkmenistan Deal May Kill Pipeline Backed by the U.S.', *Wall Street Journal*, 14 November 2000, p. 22A.

[29] Isabel Gorst and Nina Poussenkova, 'Petroleum Ambassadors of Russia: State versus Corporate Policy in the Caspian Region', Baker Institute Working Paper, April 1991, available at www.bakerinstitute.org.

[30] Douglas W. Blum, 'Russia's New Caspian Policy', Program on New Approaches to Russian Security Policy Memo, Series No. 162 November 2000.

[31] J. Fitchett, 'A resurgent Russia influence grips former Soviet Central Asia', *International Herald Tribune*, 9 July 2000.

[32] 'In the Caspian, It's all Pipelines and No Oil', *Petroleum Intelligence Weekly*, 11 September 2000, p. 3.

[33] Dorsey, James, 'Turkmenistan Deal May Kill Pipeline Backed by US', *The Wall Street Journal*, 19 November 2000 p. A22.

[34] Blum, 'Russia's New Caspian Policy'.

[35] B. Aliriza, 'US Caspian pipeline policy: substance or spin?', *Caspian Energy Update*, entre for Strategic and International Studies (CSIS) August 2000, available online at www.csis.org\turkey/CEU000117.html.

[36] B. Aliriza, *ibid*, and author's interviews with oil company executives active in the region, 26–28 November 2000.

[37] It is also important to note that the development of its Far Eastern (and Western Siberian) energy resources underscores another dimension of Russia's energy relationship with Europe. The European Bank for Reconstruction and Development (EBRD) has contracted more than $500m in loans to both Sakhalin 1 and Sakhalin 2 oil and gas projects (and several Western Siberian projects) and over the past five years. In addition, the EBRD is considering coordinating a $10bn oil and gas project offshore Sakhalin. See www.ebrd.com; Gillian Tett, 'EBRD Eyes Sakhalin Oil Plan', *Financial Times*, 11 January, 2001.

[38] See Al Troner, *Japan and the Far East: The Economics and Competitive Impact of Least Cost Gas Imports*, Baker Institute Working Paper, May 2000, James A. Baker III Institute for Public Policy at Rice University, Houston, Texas. See www.bakerinstitute.org.

[39] Vladimir Putin, 'Stability is Russia's Priority as New Oriental Vistas Open', *The Straits Times*, 9 November 2000, www.straitstimes.asia1.com.

[40] See Astrid Wendlandt, 'High Politics Help Grease Wheels of Trade', *Financial Times*, 9 April 2001.

[41] Some analysts argue that Russia's policies towards the Persian Gulf have lacked strategic focus or clearly articulated interests. Eugene Rumer, 'Dangerous Drift: Russia's Middle East Policy,' monograph published by theWashington Institute for Near East Policy, Washington DC, 2000.

[42] Ariel Cohen and James Phillips,

'Countering Russian–Iranian Military Cooperation', backgrounder published by The Heritage Foundation, 5 April 2001, no. 1425, p. 2.

[43] Author's conversations in Moscow, December 2000 and February 2001.

[44] Cohen and Phillips, 'Countering Russian–Iranian Military Cooperation'.

[45] Amy Myers Jaffe and Robert Manning, 'A World of Cheap Oil', *Foreign Affairs*, January / February 2000, pp. 16–29.

[46] US Geological Survey: *World Petroleum Assessment 2000 – Description and Results*. Diskette data series, US Geological Survey, Washington DC, Executive Summary.

[47] Sagers, Planecon presentation.

[48] Mandelbaum, address to the Conference on 'Russia and the International System', Airlie House, Virginia, 23 February 2001.

[49] Indeed, there are leaders in Russia who plainly wish to see arestoration of the country's international status in part through modernisation of its military forces. Russia's generals are pushing for a reorientation of the military toward high technology. Richard Pipes, 'Is Russia Still an Enemy?', *Foreign Affairs,* Sept / Oct 1997, vol. 76, no. 5, p. 75.